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February 18, 2009

NCUA
1775 Duke Street
Alexandria, VA 22314-3428
Attn: Mary Rupp, Secretary of the Board

First let me preface my remarks by saying that we do not participate in the corporate credit union network and are not capital stockholders of any corporate credit union. The reasons we did not participate in the corporate credit union network are outlined below. I informed the NCUA of these reasons three years ago when the NCUA was pushing to have PFFCU organize our ALM and Investment Management process to mirror that of the Corporate Credit Unions.

1. Given our asset size, we do our own back office processing and have a direct relationship with the Federal Reserve Bank.

2. The corporate credit unions are not good at lending to large credit unions. We are members of the FHLB of Pittsburgh. We use the FHLB to borrow overnight when we need temporary funding. For long term, fixed rate loans, we can borrow larger amounts at lower cost from the FHLB. The FHLB also has the ability to provide funding with some optionality which complements our mortgage loan portfolio.

3. PFFCU manages our investment portfolio internally. We buy investment securities and hold them in our own name at the Federal Reserve Bank. We perform an independent analysis of the MBS we buy. We don't need a corporate credit union to act as an investment intermediary. We didn't put any of our $1.2 billion investment portfolio with corporate credit unions because we couldn't adequately assess their credit quality. In addition, we realized their capital ratios were very thin and would not support any significant losses. To anyone who saw what happened to Capital Corporate CU in 1994, it was obvious that the corporate system had and still has a basic funding problem. They are prone to a classic "run on the bank" because their funding is from large investors who have every incentive to pull funds out at the slightest whiff of trouble because Corporate CU deposits are essentially unsecured loans. Corporate CUs are not able liquidate enough investments to stop a run on deposits without suffering losses that would eliminate their capital.

4. It was also clear that the credit ratings of the Corporate Credit Unions that were touted by both the NCUA and the Corporates themselves only applied to debt they issued to 3rd parties outside the credit union industry. That debt was highly rated, in part, because it was senior to credit union deposits. The credit ratings are just a guide, not a substitute for independent analysis by the investor because ratings always lag reality at economic turning points.

I recognize that corporate credit unions may do a good job of providing certain services to smaller credit unions but I don't believe they can compete with the alternatives available to large credit unions.

The following are my comments on the ANPR for Corporate Credit Unions under section C. Issues for Consideration. Please note that some comments appear in multiple sections because the issues are interrelated.

1. The Role of the Corporates in the Credit Union System. (page 6)

Liquidity and Liquidity Management.

It seems inconsistent to say the main purpose of the Corporates is to provide liquidity to natural person credit unions. Given that most credit unions have deposits in excess of their loans, there isn't enough loan demand from natural person credit unions to keep the Corporate CUs busy. The large Corporates acted more like hedge funds that took in large amounts of cash by offering higher yields than what a credit union could do on its own. They did not use these funds to supply liquidity to the credit union industry. Instead, the Corporates supplied liquidity to the non-agency MBS and ABS markets. The ironic twist in the current situation is that not only can't the Corporates perform their primary function of supplying liquidity; they are taking liquidity from natural person CUs to support their investment losses. The NCUA failed for the 2nd time (1994 & 2008) in its primary responsibility to regulate the Corporates so that they could help the industry in a funding crisis. **At a minimum, the NCUA needs to ensure that the Corporates can at least give back to credit unions the funds they invested.** It is going to require that the Corporates invest in shorter term securities with more stable cashflows that are matched up with the maturities of their natural person credit union deposits. If the Corporates want to invest longer term, they need to have more long term deposits. They can't operate on the assumption that they can just sell securities to fund member credit union withdrawals, which is what Lehman and Bear Stearns assumed, because it doesn't work in a time of crisis. If the NCUA can't prevent the classic run on the bank that occurs at the Corporates, then the Corporates should be disbanded or have their investment options severely limited. **Funding is the #1 problem with the Corporates that needs to be fixed. Corporate credit union deposits are inherently unstable because they are essentially uninsured, relatively short term, and controlled by a relatively small number of natural person credit unions who have every incentive and ability to withdraw their funds immediately if there is any doubt about the health of the Corporate.**

Expanded Investment Authority.

The **NCUA encouraged credit unions to place their investment funds with the Corporate Credit Unions because the NCUA allowed the Corporates to invest in higher risk securities** that were prohibited to natural person credit unions. These investment options enabled the Corporates to theoretically offer higher yields on a risk free basis than what a natural person credit union could earn on its own. The NCUA assumed it was less risky to have large sums of money invested by a small number of Corporates that had an onsite NCUA examiner, rather than have these investment dollars dispersed over a large number of natural person credit unions. The overconfidence of the NCUA gave a false sense of security to natural person credit unions that ignored the structural flaws in the corporate credit unions' balance sheet and continued to invest money into whichever Corporate CU offered the highest yield.

Given that the losses from Corporates are being passed on to natural person credit unions, even those credit unions that did not fuel the speculation by investing with a Corporate, the **NCUA should correct this error by limiting Corporate Credit Union investments to the same investments allowed for natural person credit unions.** Allowing Corporates to invest in securities not allowed to natural person credit unions raises the risk profile of the entire industry and it encourages excessive concentration of assets in a limited number of institutions. This error is compounded by the fact that Corporates have an unstable funding source that will withdraw large sums of money very quickly at the first hint of trouble.

If the NCUA is determined to maintain the expanded investment authority, then it should **raise the minimum capital requirements** for Corporates to 4% core capital (retained earnings + permanent capital) and 4% Member Capital Accounts for a total of 8%. Higher capital requirement will discourage the Corporate CUs from taking excessive risk to offer the highest deposit rates to grow assets beyond a safe level. At 8% capital, the Corporates will be operating at a 12.5 to 1 leverage ratio compared with natural person credit unions that operate at a leverage ratio under 10, on average. In addition, NCUA should require that natural person credit unions that invest in Corporates contribute member capital. There should be a significant minimum required amount of capital to join the Corporate plus some additional amount proportional to the amount of investments and loans the natural person credit union has with the corporate. This will limit natural person credit unions from rate shopping aggressively among Corporates. Rate shopping encourages the Corporates to take excessive risk because they know they will lose a large amount of deposits if they lag agency debt or other corporate CU deposit rates by as little as 10bp. **I don't understand why NCUA allowed Corporate CUs to operate with less capital than a natural person credit union since Corporate CUs have higher risk investments and an unstable funding source which is not well matched to their investments.**

<u>Structure: two tiered system.</u>

The two tier Corporate CU structure seems counterproductive to me. It created an excessive concentration of risk to have that much of the credit union system assets in one wholesale corporate credit union. The Corporates should develop the expertise to manage their investment portfolio if they want to attract natural person credit union deposits. To have another layer of operating expense (natural person to corporate to US Central) seems excessive and will lead to excessive risk taking to cover all the costs while still offering an adequate return to the member who deposited the funds in the natural person credit union. In addition, it is inherently risky for a Corporate to have all of its investments in essentially unsecured corporate debt, namely the deposits of US Central. NCUA's overconfidence in its ability to regulate led the CU industry to completely ignore a basic principle of diversification.

Field of Membership Issues.

Competition does lead to more aggressive rates to attract deposits and greater risks to earn a positive spread but it also leads to a better product at a lower cost. I have a natural bias for competition. The NCUA should require that natural person credit unions that invest in Corporates contribute member capital. There should be a significant minimum required amount of capital to join the Corporate plus some additional amount proportional to the amount of investments and loans the natural person credit union has with the Corporate. This will limit natural person credit unions from rate shopping aggressively among Corporates and should lessen the incentive for Corporates to take excessive risk to have the best deposit rates. In hindsight, it seems foolish to think that Corporates could profitably offer risk-free CD yields at higher rates than non-callable agency debt, which a natural person credit union could buy directly.

2. Corporate Capital (page 10)

Core Capital

The NCUA **should raise the minimum capital requirements** for Corporates to 3% core capital (retained earnings + permanent capital) and 4% Member Capital Accounts for a total of 7%. Higher capital requirements will discourage the Corporate CUs from taking excessive risk to offer the highest deposit rates to grow assets beyond a safe level. At 7% capital, the Corporates will be operating at a 14.3 to 1 leverage ratio compared with natural person credit unions that operate at a leverage ratio under 10, on average. The NCUA should require that any credit union investing in a corporate credit union be required to commit capital to the Corporate as well. This should slow the rush of deposits around the corporate credit union system as credit unions may not want to invest capital in too many Corporates. Requiring natural person credit unions to keep more capital at the Corporate should enable Corporates to build more capital. **I don't understand why the NCUA allowed Corporate CUs to operate with less capital than a natural person credit union since Corporates have higher risk investments and an unstable funding source which is not well matched to their investments.** Just to be clear, I would classify Corporates that put all their investment in US Central as having a higher risk investment portfolio than a well diversified natural person credit union. **Investments in US Central are essentially unsecured corporate debt.** No one would consider it prudent to run a corporate bond portfolio that only invests in one company.

Membership Capital

In order to ensure that natural person Credit Unions have a long term commitment to a corporate credit union, they need to know their membership capital is locked-up. They can't just take the high rates offered by the Corporate CU and then withdraw their funds immediately if there seems to be a whiff of trouble. The commitment of capital by natural person CUs should also help ensure that the Corporates don't take excessive risk because the Board of Directors of the Corporate consists of the CEO's of the credit unions with the capital at risk.

Since PFFCU doesn't have any capital in the Corporates, I am not familiar with their capital structure but it seems logical that the NCUA should modify membership capital so that it meets the traditionally accepted definition of tier two capital

<u>Risked Based capital</u>
It didn't work well for the banking industry and it isn't that great for credit unions. Two years ago, most people thought AAA rated private label mortgage backed securities were low risk. Financial Institutions need to have a base of capital because you don't know the scope and scale of the risks on the balance sheet until it is too late. In 1993, CMO's were considered low risk. In 1994, interest rates increased 300bp and CMO investment duration extended by years and market prices plummeted as prepayments slowed. In 2007 & 2008, it was private label MBS whose value plummeted when housing prices stopped rising and no one could figure out what loan losses were going to be and if the bonds had sufficient credit enhancements. Neither investors nor regulators are going to be able to see the next crisis. If everyone could see the next crisis in advance, there wouldn't be a crisis. **Since the next crisis in unknowable, a financial institution needs both capital and liquidity to survive the economic storm. NCUA needs to make sure the Corporates have both so they can fulfill their role of supporting natural person credit unions instead of being a drain on natural person credit unions.**

3. Permissible Investments (page 13)

Corporate credit unions should be limited to the same securities as natural person credit unions. Please see my comments in the section above titled <u>Expanded Investment Authority.</u>

4. Credit Risk Management (page 14)

For the NCUA to say "the reliability of credit ratings for investments has become more questionable" shows a great deal of naiveté on the part of NCUA. Credit ratings are and always have been backward looking indicators of economic reality. Ratings always lag reality at economic turning points for the specific bond or company being rated. Credit ratings are paid for by the seller of the bond at the time of issue. This should be clue #1 that credit ratings are only a starting point in the investment analysis process. Credit ratings are not a substitute for independent analysis by the investor. If the investor doesn't have enough expertise to analyze the bond without the credit rating, they should not buy it. We chose not to invest in the Corporate CUs because we couldn't evaluate their credit risk in a timely manner, even though they were AA rated. **Credit ratings are ONLY useful for determining which bonds to exclude from an investment portfolio. NCUA should use the ratings only in that manner.** Credit Ratings add no value with regard to telling an investor which bond to put into their portfolio.

I don't think independent evaluations in 2006 would have prevented Corporates from getting into the current mess. **The NCUA's favorite solution to every problem is hiring a consultant. It**

is rarely a good idea since it usually doesn't add value in excess of the cost. In addition, if your position is reasonable, you can always find a consultant to agree with you. In 2006, buying AAA non-agency MBS seemed like a reasonable thing to do and many consultants would have said so. The essence of running a business is allocating resources to achieve a reasonable risk adjusted return. At the end of the day, an individual has to decide which risks are worth taking. A committee or a policy or a regulation can't replace sound business judgment by a leader.

With regard to credit spread widening, NCUA should require Corporates to test the sensitivity of their portfolio. I don't think it would have helped much in this crisis because no one would have tested for the degree of spread widening that occurred. It goes back to my point regarding risk based capital that no one sees a crisis beforehand. NCUA was focused on the interest rate duration of Corporates because that was the problem in 1994. In 2007 & 2008, it was credit spread price sensitivity that got Corporate CUs in trouble. I don't think NCUA or anyone else knows what the next crisis will be.

5. Asset Liability Management (page 15)

A financial institution consists of a balance sheet and an income statement. NEV modeling only looks at the balance sheet. At PFFCU, we have a simpler balance sheet with more stable assets and liabilities and more capital than a Corporate Credit Union and we do both NEV and net income simulation analysis. We calculate the duration of our assets, liabilities, and equity monthly. We calculate our NEV in a base case and with a rate shock quarterly. We do an extensive net interest income simulation looking at net income and capital over a seven year horizon in a variety of interest rate scenarios and balance street situations at least annually. We also do a less intense version of net income analysis as part of our annual budgeting process.

I don't think NCUA should ignore net interest income modeling and stress testing, especially since NEV has a number of simplifying assumptions and provides no guidance regarding how net income will be realized over time. It is useful to know if the institution is going to lose money over the next year or two, even if it has a positive NEV over the life of its investments. I would also require credit spread sensitivity analysis since that is the current problem with the Corporate CUs investments. The only caveat is that the current credit spread widening is so dramatic that I doubt anyone what have included it in a credit spread shock analysis. Furthermore, even if someone would have considered this extreme a scenario, they most likely would not have modified their investment portfolio because they would have considered it too unlikely.

6. Corporate Governance (page 15)

I agree with minimum standards for directors of a Corporate so that a majority is competent. I don't think term limits, compensation, or an outside director would have prevented the current crisis or will prevent the next crisis. I would eliminate the wholesale Corporate CU structure. If you are not going to eliminate the wholesale corporate CU structure, then I don't see how having directors from natural person credit unions would have helped US Central. Directors of US Central CU should be from the Corporates that are its members.

To summarize, the NCUA should do the following:

a. Fix the structural flaws in the Corporate CU system with regard to liquidity.
b. Limit Corporate CU investments to the same as natural person CU investments.
c. Raise the minimum capital requirements for Corporate CUs, especially if NCUA doesn't eliminate the expanded investment authority.
d. Require natural person CUs that invest in Corporate CUs to commit significant capital.
e. Eliminate the 2 tier Corporate CU structure involving US Central.

When the NCUA is considering changes in regulation, it should consider if the change would have prevented the current problem based upon an ex ante analysis, not just an ex post analysis.

Sincerely,

John LaRosa
CEO and Treasurer of the Board of Directors
Police and Fire Federal Credit Union

Executive Summary of Police and Fire Federal Credit Union

Police and Fire Federal Credit Union has $2.9 Billion in total assets and 11% equity capital. We serve 155,000 middle income members from all professions in the Philadelphia metropolitan area. In both 1994 and 2008 when the mortgage market was in crisis, PFFCU earned 1.6% ROA. Our current balance sheet consists of roughly 45% ARM MBS and 35% real estate loans to our members. Our investment portfolio is classified as available-for-sale and has a mark-to-market gain. Real Estate loan losses were .04% during 2008. We don't do any indirect lending or business lending. We don't have a community charter and we don't do any general media advertising. Please reference the chart below for more details.

PFFCU Financial Performance	**2008**	**2007**	**2006**	**2005**	**2004**	**2003**	**2002**	**2001**	**2000**	**1999**	**1998**
Total Assets in millions of $	2,943	2,636	2,358	2,113	1,934	1,692	1,498	1,256	1,038	958	844
Net Income in millions of $	**44.7**	**31.0**	**29.5**	**26.4**	**34.3**	**22.1**	**19.3**	**13.8**	**12.1**	**11.6**	**9.5**
Total Equity in millions of $	337	298	258	223	201	172	157	132	113	94	88
ROA% (Net Income / Aver Assets)	**1.6**	**1.2**	**1.3**	**1.3**	**1.8**	**1.4**	**1.4**	**1.2**	**1.2**	**1.3**	**1.2**
Deposit Growth %	**11.5**	**11.9**	**11.7**	**9.7**	**7.3**	**13.4**	**19.3**	**21.5**	**11.0**	**10.3**	**13.9**
Loan Growth % (w/ sold 1st Mortgages)	**11.3**	**12.4**	**15.3**	**20.5**	**15.5**	**21.7**	**14.0**	**10.0**	**9.8**	**9.2**	**10.1**
Overall Member Service - % rating PFFCU superior to or better than the competition in our annual survey	**93**	**94**	**93**	**94**	**93**	**92**	**92**	**91**	**91**	**89**	**89**